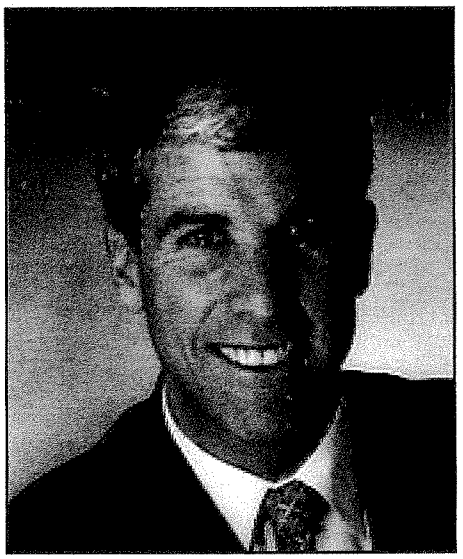
Licensing Forum



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BANKRUPTCY IS SUPPOSED to be a safe haven for debtors allowing them to reorganize and emerge as stronger enterprises. An automatic stay shields debtors against creditor lawsuits and from contract termination triggered by a bankruptcy filing. These protections even permit a debtor-licensor to avoid intellectual property licenses it has granted, leaving licensees with only unsecured claims against the bankruptcy estate. Perhaps recognizing that this protection went too far, Congress enacted Section 365(n) of the Bankruptcy Code allowing non-debtor licensees to retain rights under intellectual property license agreements that the debtor or bankruptcy trustee has rejected. Since then, several court decisions have nibbled further at bankruptcy's protections, this time in favor of non-debtor licensors. These decisions can lead to some startling outcomes, particularly for licensees under patent cross-license agreements.

For most debtors-in-possession, there is life during and after bankruptcy. In a bankruptcy reorganization, a debtor continues to operate while the case is going on and often, during this time and after it emerges from bankruptcy, the debtor-in-possession will need continued access to intellectual property rights it has licensed. Continued access to these rights is important too if the debtor's assets are to be sold—its business may be of little value if the debtor's licenses cannot be transferred to a buyer.

If a license agreement states that it cannot be assigned without the licensor's consent, Section 365(c)(1) of the Bankruptcy Code says that the agreement cannot be assumed or assigned by the debtor-in-possession or the trustee if assignment of the agreement is prohibited under applicable non-bankruptcy law. In bankruptcy cases involving patent licenses, courts look to federal patent law to determine whether the license may be assumed or assigned. The debtor-in-possession may wish to assume a license for its own continued use of the intellectual property or the debtor-in-possession or trustee may want to assign the license to a purchaser of the debtor's assets. Here in the Ninth Circuit, a debtor-in-possession cannot assume a nonexclusive patent license without the licensor's consent.[1]

The Ninth Circuit's ruling is a product of what is known as the "hypothetical test." Assignment or assumption of a patent license depends on whether federal law would prohibit assignment of the agreement to a hypothetical third party. The Court reasoned that when a patent is licensed, "the identity of a licensee may matter a great deal to a licensor."[2] The Ninth Circuit did not stop there. It held that if Section 365(c)(1) prohibits the debtor from assigning a patent license to a hypothetical third party, then it also prevents assumption of the contract by the debtor, even if assignment is not contemplated at the time.[3]

A debtor's efforts to emerge from bankruptcy may be frustrated if it is unable to assume or assign important patent licenses. If a debtor is a party to one or more patent cross-licenses, it may suffer a double blow—it not only may be denied access to intellectual property rights that it needs to run its business, but at the same time it may be forced to keep in place rights that it granted to a cross-licensee. This is what bankruptcy law expert Suzzanne Uhland, a partner at O'Melveny & Myers LLP, describes as the "Doomsday Scenario" where a debtor's attempt to assume a cross-license turns it into a one-way license.

Cross-licenses are common in industries, such as the semiconductor industry, where competitors wage patent battles with overlapping patent portfolios. Patent rights are used as bargaining chips in settling disputes. And, cross-licenses create a kind of détente, clearing patent minefields so that former adversaries can use their own patents without interference. Yet, where a cross-licensee enters bankruptcy, a court applying the "hypothetical test" may strip the debtor of the protective license shielding it from infringement claims while allowing the other party, under Section 365(n), to retain the license that the debtor granted in exchange. Fortunately, there may be at least one way to avoid this harsh result.

One approach would allow a debtor to assume its rights under a patent cross-license where the assignee's identity is irrelevant to the non-debtor party. If there is broad language in the assignment provision of the subject license agreement permitting the debtor's assignment without limiting the identity of the assignee (such as a clause permitting an assignment in conjunction with a sale of the debtor's assets), then, according to Ms. Uhland, "under a logical extension of the 'hypothetical test,' the prohibitions on assignment under applicable law do not apply." Despite support for this approach under rulings in *In re Catapult Entertainment, Inc.*[4] and *In re Hernandez*,[5] the Fourth Circuit has found that a licensor's consent to an assignment by the debtor to a successor in interest did

not apply to the debtor's "assumption" of the agreement.[6] This decision makes it nearly impossible for a debtor's assumption of a license to survive the hypothetical test without explicit language in the contract permitting assumption. "But, when license agreements are being negotiated," Ms. Uhland points out, "people usually don't talk about bankruptcy and include specific provisions for assignment or assumption."

A 2002 court decision may provide another avenue for debtor-cross-licensees. The court may allow the license agreement to 'ride through' the bankruptcy case without assignment or assumption by the debtor. This occurred in *In re Hernandez,*[7] where the court allowed the license to pass through bankruptcy to the licensee, without assumption or assignment, enabling the licensee to continue use of the license. This approach has its limitations if the licensee's bankruptcy allows the licensor to terminate the agreement, as many license agreements do. "Couldn't the licensor in this situation simply terminate the license after the debtor emerges from bankruptcy?" Ms. Uhland inquires. "*Hernandez* doesn't tell you how to deal with that."

If you would like to participate in a discussion of issues faced by licensees in bankruptcy and best practices in addressing these issues in license agreements, please join us on August 3, 2006 for a special meeting of the Intellectual Property Section Licensing Committee. This discussion is open to all members of the IP Section even if you are not a member of the Licensing Committee. To participate, please contact Kevin DeBré at kdebre@biztechlaw.com for the dial-in number and passcode. ⊙

Endnotes

1. *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747, 750 (9th Cir. 1999).
2. *Perlman,* at 752, n.4.
3. *Perlman,* at 750–755.
4. 165 F.3d 747 (9th Cir. 1999).
5. *In re Hernandez*, 285 B.R. 435 (Bankr. D. Ariz. 2002).
6. *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004).
7. *In re Hernandez*, 287 B.R. 795 (Bankr. D. Ariz. 2002).

Chair Letter

CONTINUED FROM PAGE 2

Law. We believe that it is important to inform law students of the ever increasing demand for intellectual property attorneys, and of the interesting and exciting career opportunities available. Elizabeth Powers and Joanna Mendoza added new energy to this program by hosting onsite programs at several law schools throughout the state, and with more scheduled for this spring.

As you may have surmised, we are undertaking new types of IP-related programs that we believe will be of interest to a broader audience. These include the programs focused on IP law in Asia, IP law and the Internet, and IP law in entertainment and media. If you have ideas for a particular program that you'd like to see, please let us know. We strive to bring you programs that you find beneficial to your practice.

Section initiatives this year continue to expand. The Trade Secret Standing Committee continues to be involved in new trade secret legislation. Our new Diversity Standing Committee is providing speakers for IP Section and State Bar programs, as well as reaching out to other organizations and into the community. Our new Licensing Standing Committee is chaired by Kevin DeBre (see the Licensing Forum on page 16), and has an active meeting agenda to discuss substantive issues for licensing attorneys. The Patent Standing Committee is tracking the new patent legislation, as well as the proposed new Patent Office rules of practice. We have started a new Legislation Standing Committee headed by Ben Borson. Should you have questions regarding new legislation in the IP area, we can be a resource for information.

This issue of *New Matter* is the first for our new editor, Elizabeth Powers. Elizabeth has chaired other successful programs for us in the past and we are delighted that she has agreed to take over this important post for us. We congratulate her and wish her success with our future issues of *New Matter.*

As always, thanks to our administrative staff of the State Bar of California. They work tirelessly to put on the many programs that we bring you.

You can always find us on our website at www.ipsection.org, or you can contact any one of us directly with questions and comments. Please feel free to send us any comments or suggestions you may have concerning our website, our programs and our publications. We welcome your feedback. I also urge you to get involved. We have many activities and are always looking for volunteers.

I look forward to seeing you at one or more of our programs. ⊙

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